

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE EFFECTS OF THE FEDERAL TAX REFORM ACT OF)
1986 ON THE RATES OF CONTINENTAL TELEPHONE) CASE NO. 9799
COMPANY OF KENTUCKY)

O R D E R

On September 27, 1986, the Congress of the United States passed one of the most sweeping tax reform acts in over 40 years. The Tax Reform Act of 1986 was signed by the President on October 22, 1986. As a result of this action, corporations in high tax brackets, with tax years ending on and after July 1, 1987, will realize a direct reduction in the effective income tax rate.

Normalized income taxes are a significant component of the cost of service of utilities. When the appropriate level of taxable income is determined in utility rate cases, the Commission allows an equivalent amount of revenues to cover the associated state and federal income taxes. Thus, the lowering of the tax rates under the Tax Reform Act should result in substantial cost savings to utilities in Kentucky.

The Commission is of the opinion that in order to reflect the revenue effects of the Tax Reform Act in consumer rates as expeditiously as possible, a proceeding should be established for each utility with gross revenue in excess of \$1 million. The

Commission is establishing cases for only the largest utilities at this time because the potential exists for large reductions in costs. Many smaller utilities' rates will not be affected at all by the Tax Reform Act since they are Subchapter S corporations for tax purposes. Publicly owned utilities with gross revenues less than \$1 million will be reviewed by the Commission and proceedings may be initiated at a later date. The effects of the Tax Reform Act will be considered in the general rate cases of all public utilities in the future.

The Commission is further of the opinion that the proceedings in which these revenue effects will be recognized in rates should be conducted for the sole purpose of reflecting the effects of the Tax Reform Act. The Commission has selected this approach for the following reasons.

First, it would be extremely cumbersome and expensive for the Commission to simultaneously initiate rate cases covering all utilities affected by this Order. Many utilities may not wish to incur the time-consuming and expensive task of preparing a complete rate case at this time. A proceeding that recognizes only the effects of the Tax Reform Act would minimize the time and expense of both the Commission and the utilities.

Secondly, the Commission does not view retaining the savings that result from tax reform as a proper way for a utility to improve its earnings. Likewise, if the Tax Reform Act should result in major cost increases, these costs should be recognized in rates expeditiously. If, aside from the Tax Reform Act, a utility feels that its rates are insufficient, it has the

discretion by statute to file a full rate case with the Commission. By initiating this case the Commission is in no way prohibiting or restricting any utility from filing a rate case encompassing all rate-making issues in a separate proceeding.

Finally, by initiating limited cases for every major utility, the expertise of all interested parties can be pooled to assure that all aspects of the Tax Reform Act are fairly reflected in utility rates.

Under transitional rules of the Tax Reform Act, taxpayers with fiscal years overlapping the July 1, 1987, effective date will prorate the new tax rates and use blended tax rates. Thus, a calendar year taxpayer will pay an effective rate of 40 percent in 1987, and the full 12 percent reduction in the top tax bracket will not be reflected in tax returns until after January 1, 1988. The impact of the Tax Reform Act will, in effect, be realized January 1, 1987, for taxpayers with fiscal years ending after July 1, 1987. The Commission, therefore, is strongly considering making rate adjustments effective January 1, 1987.

As a part of its testimony and supporting documentation in this case, Continental Telephone Company of Kentucky ("Continental") should address all aspects of the Tax Reform Act including the rate implementation date of January 1, 1987, and phase-in of rates reflecting the full tax reduction on January 1, 1988, for calendar year taxpayers. Furthermore, the historical test period for purposes of this proceeding should be the 12-month period ending no more than 90 days from the date of filing.

Since the intent of the Commission is to limit the controversial issues in this case to the passing on of costs or savings resulting from the Tax Reform Act, the Commission proposes for telecommunications companies to consider two rate design options involving local exchange carriers ("LECs"). First, the Commission will consider a change in local exchange access rates equal to any savings or costs resulting from tax reform. Therefore, each LEC should file revised local exchange access tariffs that equitably distribute any savings or costs among rate groups and customer classes, as well as supporting billing analysis information.

In addition, the Commission will consider a change in intra-LATA message toll service ("MTS") rates. Therefore, South Central Bell Telephone Company ("SCB") should file a revised MTS schedule and intraLATA settlement plan that changes the intraLATA settlement pool and each LEC's intraLATA settlements in an amount equal to any savings or costs resulting from tax reform, as well as necessary supporting priceout data related to the intraLATA pool and each LEC's intraLATA settlements.

In the case of interexchange carriers ("IXC"), the Commission will consider changes in MTS and MTS-type services in an amount equal to any cost savings resulting from tax reform. Therefore, each IXC under the jurisdiction of the Commission should file revised MTS schedules and supporting priceout data.

In the cases of WATS resellers, cellular telephone, radio-telephone, and paging companies subject to the jurisdiction of the Commission, the Commission will consider company option rate proposals that equitably change rates in an amount equal to any

savings or costs resulting from tax reform. Therefore, each company should file its preferred rate proposal, along with supporting billing analysis information.

In order to comply with its statutory requirements, the Commission is giving this notice that the rates currently being charged by the affected utilities are subject to change as of January 1, 1987. Such change in rates will be based on the overall impact on tax expense to each company resulting from the Tax Reform Act. Because the effect on rates will not be known until the conclusion of this proceeding, and will be different for each company, the exact change in rates cannot be determined at this time. Furthermore, because of the immediacy of the situation, the effective date of the Tax Reform Act of January 1, 1987, and the need to address these issues expeditiously, the Commission has determined, as provided in KRS 278.180, that a notice period of 20 days is reasonable.

IT IS THEREFORE ORDERED that:

1. This case be and it hereby is opened.
2. Continental be and it hereby is put on notice that its rates are subject to change to reflect the effects of the Tax Reform Act.
3. Continental shall file within 45 days from the date of this Order its prepared testimony, with detailed supporting documentation, on the effects of the Tax Reform Act and the specific issues addressed in this Order including:

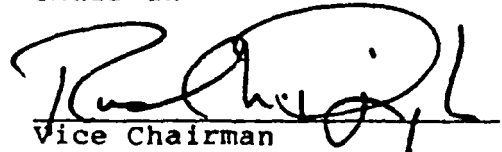
- A. The rate implementation date of January 1, 1987.
- B. The flow-through of the effects of the Tax Reform Act.
- C. The phase-in of rates reflecting the full tax reduction.
- D. Rate design.

4. Continental shall file the appropriate rate schedule(s) indicated in this Order bearing no effective date and reflecting the amount of the tax savings, with supporting documentation.

Done at Frankfort, Kentucky, this 11th day of December, 1986.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Executive Director